KANSAS

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DEPARTMENT OF CREDIT UNIONS

DATE: **June 12, 2006**

BULLETIN: **2006-KDCU-CUB-03**

TO: **Management of Kansas chartered credit unions**

SUBJECT: **Asset Diversification**

Diversification of assets is a basic principle of sound financial management. This principle is based on protection of the credit union's assets by dividing funds among various categories of investments or loans. This is done to help mitigate and manage several types of risk that are associated with any asset. The purpose of this bulletin is to advise management of the need to establish a limit for specific categories of assets. Management needs to review the structure of the credit union's loan and investment portfolios to determine the appropriate mix of assets by maturity, credit quality, and interest rate risk, ensuring appropriate diversification.

Of special note are fixed rate first mortgages, and third party controlled sub-prime and other lending programs.

Higher concentrations in fixed rate loans primarily first mortgages require credit unions to measure and forecast their balance sheet risk. The amount invested in these assets must also be limited to fit the credit union's asset liability management (ALM) polices and risk tolerance levels. Any amount over twenty-five percent of assets makes risk mitigation efforts more essential and historically difficult to justify. An adequate ALM program[1] must be in place prior to engaging in significant levels of fixed rate loans. Additionally to adequately protect members' funds, management must adhere to the principle of asset diversification.

Businesses engaging in sub-prime lending have historically experienced higher failure percentages than traditional lenders. Borrowers in this group may have a greater number of circumstances that could adversely affect their ability and/or willingness to repay the loan. Losses cannot be reliably predicted and can vary over a wider range than a portfolio of higher credit quality. These reasons alone dictate this type of lending must be limited in credit union portfolios

Sound management practices dictate the limiting of high-risk portfolios. Consequently, the Department of Credit Unions recommends credit unions establish limits for third party controlled sub-prime lending. Recommended limits may be established at 10% of total assets, 100% of net worth or another limit based on sound ALM practices[2].

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Any deviation from the established limit must be supported by a detailed plan approved by the board of directors and the Administrator, Department of Credit Unions, consistent with the credit union's overall asset liability management program.

Management is also strongly encouraged to set and adhere to internal limits for other high-risk programs[2]. Overall, management must determine the potential for higher-than-anticipated losses does not seriously jeopardize the credit union.

The Department of Credit Unions will continue to monitor through call reports and the risk based examination program asset diversification. The current rate environment offers credit unions unique member service opportunities, but balance sheet management through effective asset liability management practices must occur. Please contact our office if additional information or discussion of this topic would be helpful.

John P. Smith, Administrator June 12, 2006

1. Credit unions are encouraged to utilize ALM programs. Several commercial ALM programs are available. The Department of Credit Unions does not endorse one ALM program over others; credit unions should select the program that best meets their needs.

2. Methods to review assess and establish risk tolerance is addressed in other publications. Credit unions are referred to the National Credit Union Administration's (NCUA) Letter to Federally Insured Credit Unions 04-CU-13 Specialized Lending Activities that contains links to the AIRES Questionnaires used by the Department's examiners http://ncua.gov/letters/letters2004.html. Recently NCUA published for comment 12 CFR Parts 701 and 741 Third-Party Servicing of Indirect Vehicle Loans found at http://ncua.gov/RegulationsOpinionsLaws/proposed_regs/P-701-741.pdf.